

KELLEY DRYE & WARREN LLP

A LIMITED LIABILITY PARTNERSHIP

WASHINGTON HARBOUR, SUITE 400

3050 K STREET, NW

WASHINGTON, D.C. 20007-5108

(202) 342-8400

FACSIMILE

(202) 342-8451

www.kelleydrye.com

NEW YORK, NY

LOS ANGELES, CA

CHICAGO, IL

STAMFORD, CT

PARSIPPANY, NJ

BRUSSELS, BELGIUM

AFFILIATE OFFICES

MUMBAI, INDIA

DIRECT LINE: (202) 342-8518

EMAIL: tcohen@kelleydrye.com

June 26, 2013

VIA ECFS

Marlene Dortch, Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: American Cable Association (ACA) *Ex Parte* Filing on the Connect America Cost Model, WC Docket No. 10-90

Dear Ms. Dortch:

ACA submitted an *ex parte* filing on March 7, 2013 discussing its cost of capital calculations,¹ and subsequently filed an update in response to discussions with Commisison staff and additional information submitted into the record by the United States Telecom Association (“USTelecom”).² On June 20, 2013, USTelecom filed an *ex parte*³ containing additional inputs, methodology proposals, and a cost of capital recommendation of 9.00% for use in the Connect America Cost Model based on a “zone of reasonableness” of 8.48%-9.52% derived from the Wireline Competition Bureau’s (“Bureau’s”) May 16th Staff Report.⁴

¹ See *Ex Parte* Filing of the American Cable Association in the Virtual Workshop in Response to the Public Notice, WC Docket Nos. 10-90 and 05-337 (Mar. 7, 2013).

² See *Ex Parte* Filing of the American Cable Association, WC Docket No. 10-90 (May 2, 2013).

³ See *Ex Parte* Filing of USTelecom, WC Docket Nos. 10-90 and 05-337 (June 20, 2013) (“USTelecom *Ex Parte*”).

⁴ See “Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers,” WC Docket No. 10-90, Staff Report, DA 13-1111 (Wireline Comp. Bur. rel. May 16, 2013) (“Staff Report”); Wireline Competition Bureau Seeks Comment on Rate of Return Represcription Staff Report, WC Docket No. 10-90 et al., Public Notice, DA 13-1110 (Wireline Comp. Bur. rel. May 16, 2013).

Marlene H. Dortch
June 26, 2013
Page Two

While ACA agrees with many of USTelecom's input and methodological submissions, ACA submits that USTelecom's filing contains a number of serious flaws, which when taken in aggregate, lead to a significant overstatement of the cost of capital estimates. As such, ACA reiterates that the most reasonable approach for estimating the cost of capital range for the price cap LECs is the methodology outlined in its March 7, 2013 and May 2, 2013 *ex parte* filings. Below we review these issues in greater depth and respond more fully to USTelecom's assertions which underlie its flawed result.

Selection of Risk Free Rate

Both ACA and the Bureau in its Staff Report used the current 10-year Treasury Rate as the risk-free rate. In contrast, USTelecom seeks a longer rate duration and adjusts the rate to account for what it claims are historically low interest rates. Both of these are changes lead to a significant overstatement of the risk free rate:

- **Risk-Free Rate Duration:** The rate duration should be aligned with the duration of the project. While the broadband and voice networks may be maintained indefinitely, the risk free rate should be aligned with the duration of the CAF Phase II program. USTelecom, however, seeks a longer duration citing the fact that "economic lives for cable investments...are 20 years or more."⁵ But, USTelecom fails to acknowledge that (1) many asset categories have much shorter economic lives, and (2) the risk-free rate is part of the the overall cost of money estimate, which is a cost input used to determine support requirements over the five-year CAF Phase II time horizon. The 10-year rate is most closely aligned with the 5-year duration of the CAF Phase II program, and it would be appropriate to re-assess the risk free rate at the end of the five-year support period to determine whether costs have changed if support mechanisms were to be extended.
- **Risk-Free Rate Estimates:** Once the duration is specified, the risk-free rate used should be the current yield on a risk-free security of that duration. USTelecom, however, submits that the Bureau should include forecasts of future rates as part of its rate estimation process, because "use of a [current rate] fails to acknowledge that interest rates are at historic lows and are forecasted to increase substantially over the next several years."⁶ Using forecasts adds unnecessary subjectivity into the estimation process and would not be consistent with actual risk-free rates at the start of the project's time horizon.⁷

⁵ USTelecom *Ex Parte* at 5.

⁶ *Id.*

⁷ To further illustrate the flaws in USTelecom's 10-year risk free rate estimate of 3.70%, we can compare it to the current borrowing rates of ABC Coalition price cap local exchange carriers ("LECs"). For debt maturing over the next 10 years, Verizon can borrow at rates below

Marlene H. Dortch
June 26, 2013
Page Three

Cost of Debt Estimate

The correct cost of debt for the purposes of estimating the cost of capital is the marginal cost of debt (i.e., the cost of issuing new debt at the start of the project). USTelecom estimates the cost of debt to be the interest as a percentage of outstanding long-term debt, which includes historically issued debt of different maturities than the project's duration.⁸ Instead, it should be based on the cost of issuing new debt for the 10-year time horizon. This is consistent with principles outlined in the Staff Report indicating that "the WACC estimate for a particular project or line of business should be based on the costs of debt and equity for the project or the business line, and on the mix of financing that would be optimal for that project or business line, even if these are not independently financed."⁹

Conclusion

USTelecom revised the CAPM estimates included in the Staff Report and determined, using the flawed inputs discussed above, that the low-end cost of capital estimate for 10 price cap LECs using a weighted average is 7.16% and the forecast estimate is 8.40%.¹⁰ If these estimates were updated to include a more accurate risk-free rate and cost of debt, they would be substantially lower.

Despite the results of USTelecom's own estimates, it recommends that the actual cost of capital used for the Connect America Cost Model should be 9%.¹¹ USTelecom appears to calculate this number by taking the 75th percentile of its own "statistical inference" of the range of capital cost estimates for 10 price cap LECs included in the Staff Report, without including USTelecom's own recommended modifications. Further, according to USTelecom's estimates, all but one of the ten price cap LECs included in its analysis have capital costs below 9%.¹²

ACA reiterates that the most reasonable approach for estimating the cost of capital for each individual price cap LEC is to use the methodology outlined in our March 7, 2013 and May 2, 2013 *ex parte* filings, certain aspects of which are described above in additional detail. To determine an overall average, the individual values should be weighted by either market capitalization or the expected level of CAF Phase II eligibility. This approach would yield a more accurate result that

3.61% (as set forth in the Morningstar Public Firm Bond Profile). USTelecom's estimate implies that Verizon's debt is less risky than that of the US Government.

⁸ See USTelecom *Ex Parte* at 7.

⁹ Staff Report, n. 32.

¹⁰ See USTelecom *Ex Parte* at 9.

¹¹ See *id.* at 10.

¹² See *id.* at 9.

KELLEY DRYE & WARREN LLP

Marlene H. Dortch
June 26, 2013
Page Four

reflects the actual costs of capital for eligible price cap LECs, and is significantly lower than USTelecom's recommendation of 9%.

Should you have any questions about ACA's analysis, please contact me.

Sincerely,



Thomas Cohen
Kelley Drye & Warren, LLP
3050 K Street N.W.
Washington, DC 20007
202-342-8518
tcohen@kelleydrye.com
Counsel for the American Cable Association

cc: Steve Rosenberg
Talmage Cox
Heidi Lankau
Amy Bender